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THE ARIZONA CORPORATION COMMISSION

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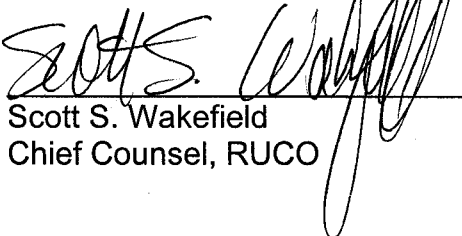
Docket No. T-01051B-99-0105

IN THE MATTER OF THE APPLICATION
OF U S WEST COMMUNICATIONS, INC.,
A COLORADO CORPORATION, FOR A
HEARING TO DETERMINE THE
EARNINGS OF THE COMPANY, THE
FAIR VALUE OF THE COMPANY FOR
RATEMAKING PURPOSES, TO FIX A
JUST AND REASONABLE RATE OF
RETURN THEREON AND TO APPROVE
RATE SCHEDULES DESIGNED TO
DEVELOP SUCH RETURN.

NOTICE OF FILING

The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing the
Supplemental Testimony of Ralph Smith and Dr. Ben Johnson regarding the Settlement
Agreement, in the above-referenced matter.

RESPECTFULLY SUBMITTED this 13th day of November, 2000.


Scott S. Wakefield
Chief Counsel, RUCO

AN ORIGINAL AND TEN COPIES
of the foregoing filed this 13th day of
November, 2000 with:

Docket Control
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24

**BEFORE THE
ARIZONA CORPORATION COMMISSION**

U. S. WEST COMMUNICATIONS, INC.

Docket No. T-1051B-99-105

SUPPLEMENTAL TESTIMONY

OF

**LARKIN & ASSOCIATES
RAPLH C. SMITH**

**ON BEHALF OF THE RESIDENTIAL UTILITY CONSUMER OFFICE
CONCERNING THE PROPOSED SETTLEMENT**

**Phoenix, Arizona
November 13, 2000**

1 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

2 A. Ralph C. Smith. My business address is: Larkin & Associates, 15728 Farmington Road,
3 Livonia, Michigan 48154.

4
5 Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS DOCKET?

6 A. Yes. On behalf of RUCO, I submitted prepared direct and surrebuttal testimony in this
7 docket.

8
9 Q. WHAT IS THE PURPOSE OF YOUR SUPPLEMENTAL TESTIMONY?

10 A. My testimony presents some of the concerns that RUCO has concerning the proposed
11 Settlement Agreement between Staff and Qwest. Another witness on behalf of RUCO,
12 Ben Johnson, is presenting testimony on other concerns regarding the settlement
13 agreement and the alternative regulation plan provided for in the settlement.

14
15 Q. SHOULD QWEST BE GRANTED AN INCREASE IN ITS ARIZONA INTRASTATE
16 REVENUES?

17 A. No. Qwest's Arizona intrastate revenues should be reduced, not increased. The
18 testimony by RUCO in this proceeding, as well as other parties such as AT&T and
19 DOE/FEA, each show that Qwest's Arizona intrastate revenues should be decreased, not
20 increased. The settlement would provide Qwest with a \$42.9 million intrastate revenue
21 increase, which, in my opinion, is not warranted.

22
23 Q. HOW WAS THE \$42.9 MILLION OVERALL RATE INCREASE PROVIDED FOR IN
24 THE SETTLEMENT DERIVED?

1 A. From the information presented by Staff and Qwest, it appears that the parties agreed to
2 use the Fair Value Rate Base and rate of return proposed by Staff, and without an issue-
3 by-issue negotiation, derived the \$42.9 million revenue increase "needed" by Qwest and
4 the adjusted net operating income number necessary to back into the \$42.9 million.
5 Apparently, Staff and Qwest considered the differences between their filed positions,
6 mainly focusing on four items, specifically: (1) software capitalization, (2) overheads
7 assigned to the sale of exchanges, (3) incentive compensation, and (4) out-of-period wage
8 and salary increases, as quantified in Staff's presentation. See Qwest's response to
9 RUCO 35-001, appended to this testimony.

10
11 Q. IN DERIVING THE \$42.9 MILLION REVENUE INCREASE PROVIDED FOR IN
12 THE SETTLEMENT, WHAT CONSIDERATION DID STAFF AND QWEST GIVE
13 TO THE RECOMMENDATIONS MADE BY OTHER WITNESSES WHO
14 PRESENTED TESTIMONY ON BEHALF OF PARTIES OTHER THAN STAFF?

15 A. It does not appear that the revenue requirement calculations of the other parties, or their
16 recommended adjustments, which in a number of instances were either different than, or
17 supplemental to, Staff's rate base and net operating income adjustments, were factored
18 into the Settlement Agreement revenue requirement. For example, the response to data
19 request RUCO 3.9 to Staff concerning the settlement states that: "The revenue
20 requirement calculations of the other parties included adjustments and positions not
21 advocated by Staff that, upon review by Utilitech, were not explicitly factored into the
22 Settlement Agreement revenue requirement." In this proceeding, of the four parties --
23 Staff, RUCO, AT&T and DOD/FEA -- presenting revenue requirement

1 recommendations besides Qwest, Staff was the only one advocating a revenue increase
2 for Qwest.¹ As detailed on RUCO Exhibit ____ (L&A-2), Schedules E-1 through E-25
3 (attached to Hugh Larkin's surrebuttal testimony on behalf of RUCO), twenty-five
4 adjustments to Qwest's proposed revenue requirement were presented on behalf of
5 RUCO. In many instances, these were different from, and in some instances
6 supplemental to, the adjustments presented by Staff. I recognize that any particular party
7 would not necessarily prevail on all of the adjustments it is sponsoring. The adjustments
8 proposed by RUCO, as well as the testimony on revenue requirement adjustments
9 proposed by other parties participating in this proceeding such as AT&T and DOD/FEA
10 should receive consideration by the Commission in determining the revenue requirement
11 for Qwest. Given the evidence presented by all of the parties in this proceeding
12 concerning the revenue requirement, I do not believe that a revenue increase for Qwest is
13 justified. The proposed settlement is unacceptable because it fails to give appropriate
14 consideration to such evidence, and to the recommendations made by RUCO, AT&T and
15 DOD/FEA showing that Qwest should have an intrastate revenue decrease.

16
17 Q. PAGE 2 OF STAFF WITNESS BROSCHE'S TESTIMONY DISCUSSES THE
18 DIFFERENCES BETWEEN STAFF'S PROPOSED AND QWEST'S PROPOSED
19 RETURN ON EQUITY. WERE THOSE THE ONLY RECOMMENDATIONS ON
20 COST OF CAPITAL MADE IN THIS PROCEEDING?

21 A. No. Staff's and Qwest's recommendations on the cost of equity and overall rate of return
22 are not the only ones that have been presented for the Commission's consideration in this

¹ Staff advocated a \$7.242 million intrastate revenue increase versus the intrastate revenue requirement increase of \$201 million on original cost rate base and approximately \$265 million on fair value rate base proposed by Qwest.

1 proceeding. RUCO witness John Legler has filed direct and surrebuttal testimony in this
2 proceeding, and has recommended an overall return of 9.51% and an 11.5% return on
3 equity.
4

5 Q. BESIDES THE REVENUE REQUIREMENT, DO YOU HAVE CONCERNS
6 REGARDING ANY OTHER PROVISIONS OF THE SETTLEMENT?

7 A. Yes. The provisions of paragraph 13 of the proposed settlement are objectionable.
8 Paragraph 13 of the settlement provides, among other things, that "... Qwest shall have
9 no obligation to refund revenues collected during the period of time the Price Cap Plan is
10 in effect" if the Arizona courts should ultimately find that the Price Cap Plan is unlawful.
11 If the Price Cap Plan or the Settlement is found to be unlawful, Qwest should be required
12 refund amounts that it collected. Removing Qwest's obligation to refund revenues
13 collected under a Plan found to be unlawful appears to me to be contrary to the public
14 interest.
15

16 Q. DOES THIS CONCLUDE YOUR SUPPLEMENTAL TESTIMONY?

17 A. Yes.

Arizona
Docket No. T-1051B-99-105
RUCO 35-001

INTERVENOR: Residential Utility Consumer Office

REQUEST NO: 001

Refer to the October 27, 2000 Testimony of George Redding, which at page 4, lines 9-13, indicates that the income available from operations was not based on a compilation of specific adjustments, but "was the product of mutual agreement using the adjusted net operating income shown on the Staff's Schedule A and approximately one half the value of the adjustments described above."

- a. Are the "adjustments described above" the adjustments mentioned at Mr. Redding's testimony, page 3, line 22, through page 4, line 2, specifically: capitalized software, overheads assigned to the sale of exchanges, incentive compensation and out of period wage and salary increases? If not, explain fully.
- b. Provide the calculation that results in "approximately one half the value of the adjustments described above" per Mr. Redding's testimony at page 5, lines 12-13.
- c. In reaching the settlement with Staff concerning the revenue increase of \$42.9 million, what consideration, if any, was given to adjustments proposed by parties other than Staff (e.g., by RUCO, DOD and AT&T) that were in addition to or different from the adjustments affecting the intrastate revenue requirement proposed by Staff?

RESPONSE:

- a. Yes.
- b. Please see Attachment A.
- c. Please see the Company's response to RUCO 35-3.

Judy Steward
State Finance Manager
1801 California St.
Denver, CO 80202

Qwest Inc.
RUCO 35-1(b)
Attachment A

Calculation that resulted in "approximately one half of the adjustments described above" ... Mr. Redding's testimony at page 5, lines 12-13.

From ACC Staff Exhibit E (page 1 of 2):

<u>Adjustments</u>		(000's) <u>Revenue Requirement</u>
C-12	Incentive Compensation	\$ (5,529)
C-13	SOP 98-1 (Income Statement)	(32,840)
B-2	SOP 98-1 (Rate Base)	(1,038)
C-14	USWC Payroll Adjustment Reversal	(13,322)
C-29	Exchange Sale Allocations Adjustment	<u>(11,416)</u>
Total Adjustments		\$ (64,145)
Divide by Multiplier (1.6995)		<u>(37,743)</u>
Divide by 2		<u><u>(18,872)</u></u>
Income Available (ACC Staff Schedule A)		134.3
Negotiated Income Available		
(Redding Testimony, page 5 & Brosch Testimony, page 4)		<u>113.7</u>
Negotiated Difference		<u><u>20.6</u></u>

QWEST CORPORATION
(U S WEST COMMUNICATIONS)

DOCKET NO. T-01051B-99-0105

SUPPLEMENTAL TESTIMONY

OF

BEN JOHNSON, PH.D.

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

NOVEMBER 13, 2000

TESTIMONY

OF BEN JOHNSON, PH.D.

On Behalf of

THE STATE OF ARIZONA

RESIDENTIAL UTILITY CONSUMER OFFICE

Before the

ARIZONA CORPORATION COMMISSION

Docket No. T-01051B-99-0105

Introduction

Q. Would you please state your name and address?

A. Ben Johnson, 2252 Killearn Center Boulevard, Tallahassee, Florida 32308.

Q. What is your purpose in submitting this testimony?

A. In this supplemental testimony I will be commenting on certain aspects of the proposed settlement agreement filed by Staff and Qwest, including the attached price cap plan. My testimony has two major sections. In the first section of my testimony, I summarize Staff and Qwest's proposed price cap plan, and the rate design aspects of Staff and Qwest's proposed settlement agreement, and I briefly discuss price cap regulation as an alternative to traditional regulation. In the second section I comment on various aspects of Staff and Qwest's proposed settlement agreement, including the attached price cap plan, and provide some concluding thoughts.

Section One

Q. Can you begin by summarizing the proposed settlement agreement?

A. Yes. Staff and Qwest have agreed upon a revenue requirement deficiency of \$42.9 million. [Settlement Agreement, ¶ 2] This is lower than Qwest sought and higher than Staff initially recommended. These parties have further agreed to recover this deficiency through a combination of certain specific rate changes resulting in a net revenue increase of \$17.6 million, and providing Qwest with the with broad flexibility to increase rates in certain other tariff categories by \$25.3 million. The following table shows a summary of the revenue changes included in the \$17.6 million revenue increase.

Table 1

Element	Revenue Increase (Decrease)
Directory Assistance	\$24,572,391
Complete-A-Call	(\$1,459,775)
Residence NRC - Low Use Option	(\$30,015)
Residence NRC - Flat Rate Service	(\$7,968,113)
Residence NRC - Reseller	(\$137,990)
Business Zone Connection Charge (NRC)	(\$170,720)
Residence Zone Connection Charge (NRC)	(\$2,267,789)
Business Zone 1 Change	(\$189,312)
Business Zone 2 Change	(\$192,888)
Residence Zone 1 Change	(\$1,497,276)
Residence Zone 2 Change	(\$1,941,876)
Carrier Common Line	(\$1,189,627)
Switched Transport	(\$357,810)
Local Switching	\$1,528,156
Interconnection Charge	(\$5,000,542)
Wholesale Directory Assistance	\$5,224
Private Line Service	\$13,697,701
Total	\$17,399,740

Finally, Staff and Qwest have proposed to have Qwest be regulated by the provisions of a price cap plan, rather than traditional rate of return regulation.

1 **Q. Can you now summarize the price cap plan which is included in the Staff and Qwest**
2 **settlement proposal?**

3 A. Staff and Qwest have proposed a price cap plan which separates Qwest's existing and
4 future services into three baskets. Basket 1 is described as "Basic/Essential/Non-
5 Competitive Services". Basket 1 includes basic local services, custom calling and certain
6 other vertical features, basic listing service, and various other services that Staff and
7 Qwest consider to be "basic", "essential" or "non-competitive". Basket 2 consists of
8 "wholesale" services, such carrier common line access, switched transport, local
9 switching, interconnection, and UNEs. Basket 3 contains "flexibly priced competitive
10 services". These are services "that have been classified as 'competitive' and also includes
11 those services for which [Qwest] has obtained flexible pricing authority". [Shooshan
12 Direct, p. 11] This Basket will also contain all new services and service packages offered
13 by Qwest. [Id.]

15 **Q. What are the proposed terms and conditions for Basket 1 services?**

16 A. Basket 1 is subject to an overall price cap based upon the weighted average price level of
17 all services contained in Basket 1. Each year, the overall price cap will be adjusted for
18 "inflation minus productivity." The measure of inflation is the annual percent change in
19 the Gross Domestic Product Price Index ("GDP-PI"), calculated and reported by the
20 Department of Commerce. The productivity offset is set at 3.7% plus a .5% "consumer
21 dividend" for a total of 4.2%. [Shooshan Supplemental, p. 5] This "inflation minus
22 productivity" calculation is capped at zero, and has no lower bound. Thus, if inflation
23 exceeds 4.2%, the price cap will not be raised. However, if inflation is less than 4.2%, the
24 cap will be lowered and Qwest will be required to lower some of the rates within this
25 basket.

26 In addition to this overall cap on Basket 1, certain basic services are individually
27 capped at their starting levels throughout the initial 3 year term of the Plan. The capped

1 services include: flat rate residential, flat rate business, 2 & 4 party services, exchange
2 zone increment charges, low use option service, service stations service, telephone
3 assistance programs, individual PBX Trunks, including features, Caller ID block, toll
4 blocking, 900/976 blocking and basic listing service. Rates for other services in Basket 1
5 may be increased up to a maximum of 25% within a given year.

6 Finally, it should be noted that all services in Basket 1 must be priced above their
7 Total Service Long Run Incremental Cost ("TSLRIC").
8

9 **Q. What are the proposed terms and conditions for Basket 2 services?**

10 A. The price cap plan provides: "Basket 2 consists of wholesale services many of which are
11 governed by their own specific pricing rules and will continue to be governed by such
12 rules, as interpreted by the Commission and the Courts, under this price cap plan". [¶ 3.b]
13 The price cap plan does provide for a change in rates for intrastate switched access. Under
14 the Plan, intrastate switched access rates will be reduced by \$5 million per year for the
15 duration of the initial 3 year term of the Plan. Qwest explains: "These \$5 million
16 decreases are intended to be revenue neutral and will be offset in the second and third
17 year of the Price Plan by \$5 million increases in the price cap applicable to Basket 3."
18 [Arnold Direct, p. 5]
19

20 **Q. What are the proposed terms and conditions for Basket 3 services?**

21 A. Services in Basket 3 are subject to a price cap equal to 110% of the weighted average
22 price level of all of the services in the Basket. However, "the additional revenue level for
23 purposes of headroom in Basket 3, shall be capped at \$25.3 million, on a test year basis,
24 for the term of the price cap plan". [¶ 4.b] Further, the price cap will be "adjusted upward
25 \$5 million in the second year of the Plan and an additional \$5 million in the third year of
26 the Plan, to reflect the switched access charge reductions in those years." [Id.] Thus,
27 Qwest will be given broad flexibility to increase and decrease prices within this basket.

1 The overall constraints are rather limited, given the "headroom" which is created by the
2 settlement. Prices for individual services and packages of services in Basket 3 must be
3 priced above their TSLRIC.

4 A Basket 1 service may be moved to Basket 3 upon a showing that the criteria of
5 Commission Rule R14-2-1108 have been met. Qwest may also package Basket 1 and
6 Basket 3 services together and include the package in Basket 3. However, the Basket 1
7 service must continue to be offered as a stand-alone service in Basket 1 at the rate set in
8 Basket 1.

9
10 **Q. What is the main goal of a price cap system as an alternative to the type of**
11 **regulation which has traditionally been used in Arizona?**

12 **A** The main goal of a price cap formula is to eliminate, or at least weaken, the linkage
13 between cost and rates, without greatly deviating from the desirable results which would
14 normally be anticipated under traditional regulation or, for that matter, under effective
15 competition (since traditional regulation is designed to simulate the results of
16 competition).

17 Once the price cap is in place, it is fixed for a specified period, usually a year. In
18 turn, the firm is expected to produce with the cost-minimizing input mix, invest in
19 cost-effective innovation, and adjust optimally to changes in input cost conditions. The
20 reason for this behavior is rooted in economic incentive. Since the firm is allowed to
21 retain as profit (or, at least, a portion of the profit) any cost reductions achieved relative to
22 the price cap, it will choose (in theory) to produce efficiently.

23 With an appropriate price cap formula, prices are controlled by the price cap
24 formula; in turn, this reflects the normal variations in the prices of inputs used by the
25 firm, offset by the expected productivity improvements encompassed by the formula.
26 This contrasts with traditional regulation, where prices remain constant between rate

1 cases, and are varied within the context of a rate case based upon whatever changes have
2 occurred in costs and productivity since the prior proceeding.

3 With a price cap system, prices are regulated by focusing on changes in the overall
4 level of costs that the firm faces (inflation of input costs), and subtracting the impact of
5 productivity or expected productivity growth as it impacts the industry generally.

6 Although the price cap should logically rise if the prices of a firm's inputs rise, the price
7 cap is not linked directly to changes in the specific cost of service of the firm in question;
8 instead, the system looks at inflation generally. Thus, carrier-specific cost changes do not
9 necessarily lead to price changes, and management's incentive to minimize costs is not
10 diluted.

11
12 **Q. Can you clarify how a price cap formula differs from traditional rate base**
13 **regulation?**

14 A. Yes. When a price cap system is initially instituted, it closely resembles traditional
15 regulation, since the price cap will most likely be based upon the existing tariffs, or some
16 traditional measure of a reasonable set of prices. Over time, however, the two systems can
17 diverge somewhat. The price cap approach allows the firm to vary its overall price level
18 in accordance with industry-wide factors, while traditional regulation allows it to vary its
19 price level in accordance with Company-specific data (in a rate case).

20
21 **Section Two**
22

23 **Q. Lets turn to the second major section of your testimony. What specific aspects of**
24 **the proposed settlement agreement will you discuss?**

25 A. First, I will discuss the proposed beginning rates and associated rate design. Second, I
26 will comment on the proposed inflation index and productivity offset. Third, I will
27 discuss the specific baskets used to group existing services and classify new services

1 under the proposed settlement agreement. Fourth, I will comment on the pricing freedom
2 within each basket. Finally, I will discuss the service quality provisions of the proposed
3 settlement agreement.

4
5 *Beginning Rates*
6

7 **Q. Let's discuss the first aspect of the settlement agreement that you mentioned. Are**
8 **the beginning rates important under a price cap plan?**

9 A. Yes. The initial starting point, the price that is established when first going into price cap
10 regulation, must be the "correct price" for this system of regulation to yield optimal
11 results. These rates are typically based on the same cost-of-service and rate of return
12 criteria used under traditional regulation. If the initial price cap is set too high, the firm
13 may generate monopoly profits, unrelated to the skills and performances of its labor and
14 management. If the price cap is set too low, the firm may incur losses or achieve a return
15 which is far below its cost of capital. In that case, it will turn to the regulator in order to
16 seek a higher price cap, abandonment of the price cap system, or other changes which will
17 bail it out of its difficulties. Most regulators adopting price cap plans have either started
18 with the firm's existing tariffs, or have required a downward reduction in those rates at
19 the time the plan is initiated.

20 When initiating a system of price cap regulation, current and anticipated profit
21 levels are of special concern. If the firm is not earning its cost of capital, capping prices at
22 their existing level may deny the firm an opportunity to overcome the existing deficiency,
23 and thus hold profits below a normal level for many years into the future. The converse is
24 also true. If current rates are yielding a return that is significantly above the cost of
25 capital, by capping prices at the current level, excess profits may continue for many years
26 into the future.
27

1 **Q. Do you think it would be appropriate for the Commission to accept the proposed**
2 **starting rate levels included in the proposed settlement?**

3 A. No. It is my understanding that the Commission is looking at the proposed settlement
4 without evaluating all of the evidence concerning Qwest's current profit level. In my
5 opinion, the level at which prices will be capped is crucially important. This issue cannot
6 be adequately resolved without examining the evidence that current rates are too high, or
7 the evidence that current rates are generating excess profits—profits which will increase
8 even further as the merger “synergies” are achieved.

9 The proposed \$42.9 million increase is certainly more reasonable than the
10 Company's previously requested \$86 million revenue increase. However, as explained by
11 RUCO witnesses Ralph Smith and Hugh Larkin in their previously filed testimony,
12 RUCO is convinced that Qwest is currently earning more than its cost of capital, and thus
13 a substantial revenue reduction would be appropriate. Furthermore, in other jurisdictions
14 LECs have often accepted, or been required to implement, rate reductions in order to gain
15 the increased pricing freedom and other benefits of price cap regulation. These reductions
16 are in addition to the price adjustments associated with productivity offset and other
17 features of the actual price cap mechanism. Thus, from RUCO's perspective, one of the
18 most disturbing aspects of the proposed settlement is that it “fast-tracks” a substantial rate
19 increase under circumstances where a rate decrease would be much more appropriate.
20 Moreover, the impact of this rate increase will tend to be even greater than if traditional
21 regulation were to continue to be in force. The price cap plan could “lock in” excess
22 profits for years to come. To the extent the Qwest merger results in substantial cost
23 savings and other “synergies,” for example, ratepayers may not have any opportunity to
24 share in the benefit of these synergies, if the price cap plan is accepted—particularly if the
25 plan is renewed or extended beyond its initial three year duration.

1 **Q. Are you aware of any instances in which other jurisdictions have required a**
2 **reduction in starting rates at the time a price cap plan is implemented?**

3 A. Yes. In Illinois, Ameritech was required to reduce its starting rates by \$93,000,000, based
4 upon an authorized Return on Equity of 11.97% [Regulatory Reform - A Nationwide
5 Summary, Issue No. 17, BellSouth Telecommunications, June 1995]. In Maine, Nynex
6 accepted a \$14,400,000 reduction in starting rates, based upon a Return on Equity of
7 12.5%. [Id.] In Wisconsin, Ameritech accepted a 10% reduction in basic service prices,
8 followed by a three year freeze on residential and small business local service. [Id.] In
9 New York, Nynex accepted a \$170,000,000 (3.5%) reduction in its rates, based upon a
10 10.8% Return on Equity. [Id.] Southwestern Bell agreed to a \$84,600,000 reduction in its
11 rates in Missouri at the onset of an alternative regulatory system. In North Carolina,
12 BellSouth agreed to a \$15 million revenue reduction at the beginning of price regulation,
13 and an additional \$45 million reduction phased in over the 3 year life of the plan.
14 [BellSouth Telecommunications, Inc.'s Statement of Acceptance of Price Regulation,
15 Docket No. P-55, Sub 1013]. Other LECs have agreed to phased-in reductions in certain
16 rates over the first few years of the plan, or have committed to substantial increases in
17 their infrastructure investments, either in lieu of, or in addition to, reductions in starting
18 rates as part of the "quid pro quo" for being granted authority to operate under price cap
19 regulation. [Regulatory Reform - A Nationwide Summary]

20 These examples stand in stark contrast to the substantial rate increase which is
21 included in the proposed settlement agreement. It is not unusual for an LEC to accept a
22 substantial rate decrease as the "price of admission" into a price cap plan. Under the
23 terms of the proposed settlement agreement, in contrast, Qwest would get increased
24 pricing flexibility and other benefits of price cap regulation without having to reduce its
25 overall rate level; to the contrary, if the settlement were accepted, it would be given the
26 bonus of being allowed to increase its revenues.

Q. How would this proposed revenue increase be spread across the three service baskets?

A. Schedule 1 is adapted from Attachment B to the settlement agreement. It shows the proposed rate and revenue changes for the three service baskets. As shown, Staff and Qwest propose to reduce annual Basket 1 and Basket 2 revenues by \$14.4 and \$5.0 million, respectively, and increase Basket 3 revenues by \$62.1 million.

As shown on Schedule 1, Basket 1 revenues will be decreased by:

- Lowering Residential non-recurring charges
- Eliminating the residential and business zone connection charges, and
- expanding zone 1 and zone calling areas

Basket 2 revenues will be reduced by:

- Lowering the carrier common line rate
- Raising and lowering various switched transport rates
- Adding 2 new switched access rate elements, and
- Reducing the interconnection charge

Basket 3 revenues will be increased by:

- Increasing the directory assistance charge
- Eliminating the complete-a-call charge
- Raising and lowering various private line rates
- Increasing unspecified rates by \$25.3 million

1 **Q. How does this compare to your previous rate design recommendation?**

2 A. Schedule 2 shows my earlier recommendations, as set forth in revised Schedule 5 which
3 was attached to my surrebuttal testimony, organized around the three baskets included in
4 the proposed settlement. For instance, I recommended a \$4.8 million reduction in Basket
5 2 revenues, which is roughly the same as the \$5.0 million first year decrease included in
6 the settlement agreement. However, the settlement calls for two additional \$5 million
7 decreases to switched access rates, which go far beyond Qwest's original request or my
8 recommendation. As shown on Schedule 2, I have recommended a \$26.6 million increase
9 in Basket 3 revenues, compared to the \$62.1 million increase allowed under the
10 settlement agreement. For basket 1 revenues, I have recommended a \$47.8 million
11 decrease, compared to the \$14.4 million decrease proposed by Staff and Qwest.

12
13 **Q. What is your conclusion with regard to the rate changes which are set forth in the**
14 **settlement agreement?**

15 A. Obviously, the proposed \$43 million increase is a significant improvement over the \$83
16 million increase previously requested by Qwest. Further, the entire increase (and then
17 some) would be borne by Basket 3 services, which would also be a significant
18 improvement over the Company's previous proposal, which included an excessive
19 increase in local rates. If the Commission accepts the proposed \$43 million increase
20 (which I don't recommend), my primary concern is the potential increase in Basket 3
21 rates, particularly if additional services are subsequently moved into this basket. The
22 \$25.3 million of "headroom" provides an opportunity for dramatic increases in individual
23 services. This headroom will be increased to \$35.3 million by the third year of the plan.
24 Further, as I explain in more detail later, the price cap plan allows virtually unlimited
25 freedom to increase rates for individual Basket 3 services, particularly if Qwest decides to
26 reduce some of the rates in this basket. Even without making any reductions, it could

1 place the entire \$35.3 million increase on a single service, or a small handful of services,
2 thereby giving it the freedom to increase these particular rates by ten-fold, or more.
3

4 *Inflation Index and Productivity Offset*
5

6 **Q. Let's discuss the next aspect of the proposed price cap plan. Would you please**
7 **elaborate on the inflation variable?**

8 A. Certainly. One of the key variables in the proposed plan, as with most price cap plans, is
9 the inflation index that will be used to determine the annual price cap. Once appropriate
10 starting rates are set, an appropriate index is typically used as an indication of the extent
11 to which overall price levels should be changing over time. In competitive industries, in
12 the market clearing price level tends to equilibrate in the vicinity of the average level of
13 costs incurred by members of the industry. Furthermore, one of the factors which
14 influence price levels in the short run is the level of input costs incurred by the firms.
15 Hence, if a price cap system is to be reasonably consistent with the pattern in competitive
16 markets, prices should be determined, at least in part, by changes in the overall level of
17 input costs experienced by firms in the industry.

18 Ideally, prices would be indexed to an accurate measure of the overall composite
19 level of input costs borne by local exchange companies like Qwest. This composite would
20 consider the cost of materials, labor and services that are used by the firm to produce the
21 services whose prices are controlled by the price cap system. With such an index,
22 regulators would be able to focus on industry-wide changes in input costs, without linking
23 prices too closely to the individual firm's cost level. If Qwest is able to operate more
24 efficiently, and thus incurs lower than average costs, it will gain the benefit of that
25 efficiency. Yet, all firms are given the benefit of the opportunity to increase prices when
26 their input costs are increasing, and customers are given the benefit of potentially lower
27 prices when input costs are declining.

1 Unfortunately, no industry-specific index of input prices exists. Hence, regulators
2 normally turn to one of the broader inflation indices, as a reasonable proxy for an index of
3 telecommunications input costs. One option is the Consumer Price Index (CPI). While
4 it's widely known and well understood, the CPI measures changes in the cost of final
5 goods purchased by households, and thus it isn't very representative of changes in the
6 cost of input factors used by carriers. Another alternative is the Producer Price Index
7 (PPI). The PPI measures changes in the prices purchased by producers. However, the PPI
8 in the aggregate includes numerous components that may not be inputs specific to the
9 telecommunications industry. The Department of Commerce, Bureau of Economic
10 Analysis also reports changes in the individual components that comprise the PPI.

11 Theoretically, one could choose those PPI subindices that best reflect the specific
12 inputs used in the industry, and combine these with an index of labor costs, in order to
13 arrive at a reasonable estimate of changes in input costs. For example, one could weight
14 the changes in the PPI for communications equipment, computers, and other items
15 purchased by LECs with an index of labor costs. However, there would be at least three
16 disadvantages to this approach: it would be time consuming, it would be controversial,
17 and it would not necessarily be reliable. All price indices have limitations; these
18 limitations potentially become more significant as one moves from the macro to the
19 micro level. Thus, for example, the PPI subindex for telecommunications equipment is
20 potentially influenced by data gathering limitations, calculation errors, or other problems
21 that tend to be far less significant or noticeable in the overall PPI.

22 In their proposed settlement agreement, Staff and Qwest use the GDP-PI in
23 developing the price cap each year. The GDP-PI looks at the entire economy, as measured
24 by Gross Domestic Product. Thus, it is an even more broadly based index than the CPI
25 and PPI. Therefore, it is less volatile and potentially less subject to data gathering
26 limitations and other problems. However, if the GDP-PI is used, it must be clearly
27 understood that it is not an accurate index of changes in the production factors faced by

1 any one particular industry. The GDP-PI is a reasonable proxy for the overall rate of
2 inflation in the U.S. and it can reasonably be relied upon in developing a price cap system
3 for a particular industry, provided that appropriate downward adjustments are made.
4

5 **Q. Could you explain these adjustments?**

6 A. Ideally, if a broad inflation measure, such as the GDP-PI, is used, an adjustment should
7 be made to account for the differences between the rate of inflation in input prices within
8 the particular industry and the overall rate of inflation. Historically, inflation has
9 fluctuated widely, with large up swings and down swings. Input costs within a particular
10 industry will not necessarily follow the same inflation pattern experienced by the overall
11 economy. For example, in recent years LEC input prices have not increased as rapidly as
12 price levels in the economy generally. It is well known that electronic equipment is not
13 increasing in cost as rapidly as the overall rate of inflation. In fact, some equipment, such
14 as computers, is actually declining in cost. Because of the importance of electronic
15 equipment to the telecommunications industry, the GDP-PI tends to overstate the rate of
16 inflation applicable to the items purchased by the LECs.
17

18 **Q. In addition to input price discrepancies, are there any other reasons why a**
19 **downward adjustment should be made to the inflation index in developing a price**
20 **cap system?**

21 A In price cap regulation, an adjustment for productivity changes is needed, to ensure that
22 reasonably anticipated increases in LEC productivity are reflected in the price cap index,
23 and thus in end user rates charged by the LECs. Such an adjustment would allow
24 ratepayers to share not only in the long-term benefits of price-cap-induced efficiencies,
25 but in the short-term benefits as well. Ideally, the productivity differential would reflect
26 changes in telecommunications productivity in a manner that simulates the impacts of
27 productivity changes in a competitive industry. However, if the selected productivity

1 measure is inaccurate, it cannot serve these stated purposes. Furthermore, even if a
2 reasonable figure is selected based upon historic data, there is no assurance that future
3 productivity changes will be equivalent to the past. In a competitive industry, if there is a
4 technological breakthrough, or if the total volume of production increases enough to
5 increase economies of scale for the typical firm, most of the benefits will flow to
6 consumers, though possibly after a lag.

7 With price cap regulation, in contrast, an increase in productivity over the historic
8 trend will tend to result in windfall gains to the carrier, since the price cap will not decline
9 as rapidly as costs are declining, or as rapidly as prices would drop in a competitive
10 market.

11
12 **Q. Have any studies been performed to measure changes in productivity in the**
13 **telecommunications industry?**

14 A. Yes. Probably the most widely cited studies are those relied upon by the FCC to establish
15 productivity offsets for price cap regulation of certain local exchange companies. In
16 various proceedings over the past 10-15 years, the FCC has reviewed numerous
17 productivity studies prepared by FCC staff, industry participants, and other interested
18 parties.

19
20 **Q. What has the FCC concluded from its review of these studies?**

21 A. The FCC has concluded that the telecommunications industry is one of the sectors of the
22 economy where productivity is growing very rapidly. [See, e.g., In the Matter of Policy
23 and Rules Concerning Rates for Dominant Carriers, Report and order, April 17, 1989,
24 Docket No. 87-313, FCC 89-91, para. 200]. Furthermore, the FCC's conclusions in this
25 regard have been strengthened and expanded over the years.

1 In 1989, citing several productivity studies, the FCC concluded that 2.5% was the
2 best estimate of LEC productivity. The FCC also concluded that the productivity offset
3 should include a .5% "Consumer Productivity Dividend". [Id., para. 693].

4 In 1990, after reviewing additional studies the FCC concluded that the
5 productivity offset should be increased to either 3.3% or 4.3% depending upon the level
6 of profit sharing an LEC chooses. [In the Matter of Policy and Rules Concerning Rates
7 for Dominant Carriers, Second Report and Order, September 19, 1989, Docket No.
8 87-313, FCC 89-91, para. 74].

9 In 1994, the FCC initiated a docket to review LEC performance under the price
10 cap rules established in 1990. [In re: Price Cap Performance Review for Local Exchange
11 Carriers, CC Docket No. 94-1, FCC 95-132.]. After evaluating an array of new studies
12 and evidence, the FCC concluded that a range of 4.0% to 5.3% would be appropriate for
13 the productivity offset, depending upon the extent of profit sharing, if any, that would be
14 applicable. Although this factor is only applied to the interstate jurisdiction, the FCC
15 accepted the arguments of the U.S. Telephone Association (USTA) that it should base its
16 productivity factor on the overall industry productivity rate, including both interstate and
17 intrastate services.

18 In 1997, based upon additional productivity studies, the FCC revised its price cap
19 "X-Factor" to 6.5%, reflecting 6.0% productivity and a 0.5% consumer dividend.
20 However, it should be noted that this decision was appealed and subsequently remanded
21 to the FCC for further proceedings. During those proceedings, various parties proposed
22 X-Factors ranging from 3.7% to 11.2% [See., Sixth Report and Order, Docket 94-1, May
23 31, 2000, ¶ 139] On remand, the FCC adopted an access charge reform proposal put
24 forth by the Coalition for Affordable Long Distance Service ("CALLS"). [Id.]. The
25 CALLs proposal included a 6.5% "X-Factor". However, under the CALLS proposal, the
26 X-Factor is used as a transitional mechanism to reduce access charges to targeted levels,
27 rather than simply as a productivity offset. This decision has also been appealed.

1 **Q. What is your reaction to the productivity offset included in the proposed settlement**
2 **agreement?**

3 A. While this is probably less than the factor which would be justified by a detailed
4 examination of the evidence, this is one of the less objectionable aspects of the settlement
5 agreement. An productivity offset of 3.7% plus a consumer dividend of 0.5% results in a
6 4.2% offset, which is a bit higher than the analogous factors adopted in other states,
7 where offsets of 3% to 4% are not unusual.

8 However, it is significantly less than the 6.5% offset which was most recently
9 adopted by the FCC, and it is significantly less than the 5.3% offset chosen by most LECs
10 under the FCC's previous sliding scale. The latter figure is particularly significant, since
11 it provides an indication of the actual level of productivity improvement these firms
12 believe they will be able to achieve. When given the opportunity to choose from a sliding
13 scale of 4.7, 5.0 and 5.3 percent offsets with associated profit sharing levels, most LEC's
14 chose the 5.3 percent offset. This allowed them to retain any and all excess profits they
15 may be able to achieve under the price cap system. However, unless they anticipate
16 achieving at productivity improvements in this range, any such excess profits would not
17 materialize. Accordingly, the 5.3% choice is logically consistent with an expectation that
18 productivity will grow in the range of 5.3% or more. Further, some states that set
19 productivity factors in the 3% to 4% range several years ago, are discovering that
20 companies operating under such price cap plans are significantly overearning—another
21 indication that the 3% to 4% range is too low.

22 Moving from a known (traditional regulation) to an unknown (price caps)
23 involves a certain amount of risk for customers. By selecting a relatively high offset
24 factor, the Commission could help ensure that consumers will be treated fairly under the
25 new system, by ensuring that consumers benefit from decreases in cost and increases in
26 productivity that can be expected in the future.

1 **Q. Are you suggesting that the Commission should accept Staff and Qwest's**
2 **productivity offset?**

3 A. No, not unless the "going in" rates are substantially reduced. As I said, 4.2% is within a
4 plausible range for this particular variable, when looked at in isolation. However, under
5 the current circumstances, RUCO cannot endorse this figure. For one thing, Qwest is
6 expecting to achieve substantial cost savings and "synergies" as a result of its recent
7 merger, which will effectively allow it to achieve higher than normal productivity gains.
8 Also, the settlement calls for a revenue increase despite the fact that Qwest is currently
9 earning excess profits, as explained in the testimony of RUCO witness Ralph Smith.
10 Given this factual context, the 4.2% productivity offset is too low.

11
12 *Service Baskets*

13
14 **Q. Let's discuss the third aspect of the settlement agreement you mentioned. Are the**
15 **baskets proposed by Staff and Qwest appropriate?**

16 A. The plan appropriately separates wholesale and retail services into distinct baskets. I
17 strongly approve of placing all of the wholesale services offered to Qwest's competitors
18 into a distinct "wholesale" basket, which is separate from the analogous retail services.
19 As the Commission knows, the level and structure of the incumbents' wholesale rates will
20 play a key role in either promoting or discouraging effective competition, particularly
21 where incumbents retain a de facto monopoly on the provision of needed facilities. By
22 separating these categories, the Company will have less opportunity to use its pricing
23 flexibility in an anticompetitive manner.

24 While I approve of this aspect of the proposed plan, other related aspects of the
25 plan are seriously deficient. In general, the three service baskets are too broad, and the
26 basis of classification is too ambiguous and confusing. Further, the rules governing the
27 classification of new services should be clarified and strengthened.

1 **Q. Why should the price cap plan utilize more baskets than proposed by Staff and**
2 **Qwest?**

3 A. As I explained earlier, the Plan distributes all services into just three service
4 classifications. ("Basic/Essential Non-competitive"; Wholesale"; and, "Flexibly Priced
5 Competitive"). This is the bare minimum number of classifications which is feasible, and
6 I believe a larger number of baskets (or sub-baskets) would be desirable. To begin with, I
7 have some concerns with the proposal to lump residential and business customers in the
8 same category, since this could facilitate a drastic restructuring of the rates paid by these
9 two groups.

10 Both business and residential customers purchase essential services that are
11 currently provided in a quasi-monopoly environment. However, these groups are not alike
12 in their competitive characteristics. It is likely that the greatest degree of competitive
13 pressure will be experienced in the business market--at least in these early stages of
14 competition. Competitors have reason to anticipate that the business market will have the
15 highest profit margins. Also, the total volume of service purchased by each customer
16 tends to be higher (particularly for multi-line business customers); this means that
17 competitors can more easily gain a given level of revenues by focusing on relatively few
18 buyers. Finally, many business customers are viewed as quality-conscious, and thus
19 carriers can more easily follow an entry strategy that does not simply emphasize cost
20 savings. Given the likely differences in competitive pressure facing the business and
21 residence categories, the Company will have strong incentives to reduce business rates
22 and increase residence rates, to the extent allowed by the Plan.

23
24 **Q. Doesn't the cap on flat rate residential service ameliorate this concern?**

25 A. Yes, to a substantial degree. However, it is unclear how long this cap will last. The plan
26 provides that the caps will last "throughout the term of the plan". [¶ 2(c)(i)] At least
27 initially, the term of the plan is just 3 years. [¶ 6(a)] After this initial term, Qwest may

1 propose to renew the plan with the same terms and conditions or with proposed revisions.
2 Further, the proposed settlement agreement provides: "Renewal or modification of the
3 price cap plan at the end of the initial term is subject to approval by the Commission.
4 Until the Commission approves the price cap plan, or orders a termination of the Plan
5 after its term, the Plan shall continue in effect." [Settlement Agreement, p. 6] Therefore,
6 as explained by Qwest, "if the Commission takes no action on the application for
7 extension or revision, the plan remains in effect". [Response to RUCO 33-4]. While these
8 provisions seem adequate to initially protect residential customers against excessive rate
9 increases, I am concerned that the absolute cap on prices may seem anachronistic after 3
10 years, and thus this protection may not last.

11 In my opinion, it would be preferable to protect residential customers from
12 excessive rate increases through caps on individual rate elements (as I discuss elsewhere
13 in my testimony), or through structural separation (placing residential and business rates
14 in separate baskets or sub-baskets). Ideally, the Commission would place residential and
15 business local exchange services into separate baskets, with appropriate rate element
16 pricing restrictions for each. If business service is placed in a different basket than
17 residential service, the Company will not have as much freedom or incentive to
18 "rebalance" rates by increasing residential rates and decreasing business rates. As a result,
19 differences in market conditions or the degree of competitive pressure will tend to
20 translate into differences in the rate of decline in rates, rather than decreases in some
21 market segments, offset by increases in others segments. Also, the Company will have
22 less freedom to engage in anti-competitive pricing strategies if the plan were structured in
23 this manner.
24
25

1 **Q. In addition to separating business and residential services into separate baskets, do**
2 **you recommend further differentiation between services?**

3 A. Yes. The proposed settlement would divide retail services into 2 baskets; one in which
4 prices are strictly controlled, and one in which the Company has virtually unlimited
5 pricing freedom. Accordingly, any attempt to reclassify Basket 1 services will potentially
6 initiate a high stakes battle. It would be better to structure the plan in a way that avoids
7 this "all or nothing" approach. With more baskets, the Commission would have more
8 flexibility in achieving a gradual progression from strict price regulation to complete
9 pricing freedom.

10 For example, retail services could be grouped into the following baskets or sub-
11 baskets: Residence Basic; Business Basic; Discretionary; Emerging Competitive; and,
12 Fully Competitive. Qwest would be given a limited degree of freedom to modify prices in
13 the "Discretionary" basket, and it would be given even more freedom to adjust prices in
14 the "Emerging Competitive" basket. Near-total pricing freedom, as contemplated for
15 basket 3 under the proposed settlement, would be reserved for the "Fully Competitive"
16 basket under this approach. Establishing additional subcategories makes it easier to vary
17 the pricing rules that apply to each group, based upon differences in the characteristics of
18 these services, and it avoids the problems which arise when subtle variations in the
19 degree of competition are ignored. Under the approach used in the proposed settlement,
20 for example, prices are rigidly controlled until the moment the service is declared to be
21 "competitive" and thereafter Qwest would have virtually unlimited pricing freedom. This
22 extreme dichotomy in pricing flexibility completely ignores the fact that competition
23 tends to emerge gradually, and that few markets can be characterized as purely
24 competitive or purely monopolistic. The typical market will display some of the
25 characteristics of competition, at least to a limited degree, while also displaying some of
26 the characteristics of market power. Given these typical circumstances, under the
27 proposed settlement the Commission will be forced to make a black and white decision

1 between two extremes—either by emphasizing the competitive aspects of the situation and
2 ignoring the evidence of lingering market power, or by emphasizing the monopolistic
3 aspects of the situation and ignoring the evidence of emerging competitive pressures. The
4 Commission should not be forced to make a simplistic distinction between “competition”
5 and “monopoly.” A good price cap plan will provide it with an opportunity to classify
6 each service in accordance with the subtle nuances of actual market conditions.
7

8 **Q. What about wholesale services?**

9 A. It is desirable to keep these separate from retail services. This is one of the good features
10 of the proposed settlement. However, this category would ideally be subdivided into at
11 least 2 separate baskets or sub-baskets, for essentially the same reasons I just discussed.
12 Moreover, some wholesale services must be priced in accordance with federal law (e.g.
13 UNEs), and thus pricing flexibility isn’t really appropriate, while other wholesale services
14 are regulated under state law. An example of the latter category might include the services
15 that Qwest provides to the competitive firms that operate pay phones, or customer owned
16 coin operated telephones (COCOT), as they are sometimes called. It might be legally
17 feasible to provide Qwest with a degree of flexibility in pricing these wholesale service.
18 For example, as competitive local exchange carriers like MCIWorldcom gain a larger
19 share of the local exchange market, they may increasingly provide a viable alternative for
20 COCOT operators, and thus it might be appropriate to provide Qwest with additional
21 flexibility in pricing the services it provides to the COCOT operators.
22

23 **Q. You mentioned that the basis for classifying services into individual baskets is**
24 **ambiguous and confusing. Can you explain this criticism?**

25 A. Basket 1 is labeled “Basic/Essential Non-competitive Services”. Basket 3 is labeled
26 “Flexibly-Priced Competitive Services”. As I explained earlier, Mr. Shooshan stated in
27 his direct testimony that Basket 1 consists of “all services that [Qwest] currently offers

1 which have not been classified as 'competitive' or which are not currently afforded
2 flexible pricing". The proposed Plan further provides that Basket 3 includes "those
3 services that have been accorded pricing flexibility or have been determined by the
4 Commission to be competitive under A.A.C. R14-2-1108". [¶ 4(a)] Rule 14-2-1108
5 provides:

6
7 A telecommunications company may petition the Commission to classify
8 as competitive any service or group of services provided by the
9 company.... The petition for competitive classification shall set forth the
10 conditions within the relevant market that demonstrate that the
11 telecommunications service is competitive....
12

13 The rule further provides a list of specific information that must be provided as evidence
14 of the competitiveness of the service or group of services in question.

15 Although the operative distinction between Basket 1 and Basket 3 seems to be the
16 degree of competitiveness associated with the service, the Basket 1 label seems to imply
17 that a further distinction is the degree to which the service is "basic" or "essential". This
18 creates potential for confusion in the not uncommon situation where a service is not basic
19 or truly essential, but it is not fully competitive either. By having only 2 retail baskets, the
20 Plan effectively assumes that all non-competitive services are basic and essential, and that
21 all competitive services can appropriately be grouped together as being neither basic nor
22 essential. If this simplistic dichotomy were to be retained, any retail service which is not
23 fully competitive should remain in Basket 1, regardless of whether or not it is basic, and
24 regardless of whether or not it is essential. If this is the intent, then it would be
25 appropriate to change the name of this basket to eliminate the words "basic" and
26 "essential," thereby clarifying that the distinction between baskets is strictly based upon
27 whether or not a service is competitive. However, an even better solution would be to this
28 awkward dichotomy by adding additional baskets, or sub-dividing the baskets into more
29 logical groupings, as I suggested earlier.

1 **Q. Can you illustrate the approach you are recommending with regard to the service**
2 **baskets?**

3 A. Retail services could be separated into at least 4 baskets or sub-baskets, and wholesale
4 services could be separated into at least 3 subbaskets, as shown below:

- 5
- 6 ● Retail Services
 - 7 ▶ Basic Residence
 - 8 ▶ Basic Business
 - 9 ▶ Discretionary
 - 10 ▶ Emerging Competitive
 - 11 ▶ Fully Competitive
- 12 ● Wholesale Services
 - 13 ▶ UNE's
 - 14 ▶ Switched Access
 - 15 ▶ Special Access and Other Wholesale Services

16

17 **Q. What are the problems associated with classification of new services?**

18 A. The plan provides that all new services and service packages will be placed into the
19 competitive basket, subject to Commission consideration as provided in A.R.S. § 40-250.
20 This statutory provision sets forth certain procedural requirements regarding hearings on
21 rate changes and other proposed changes in operations.

22 This approach is fatally flawed, because it doesn't contemplate the possibility that
23 a new service or service package might more appropriately be classified as non-
24 competitive. Just because something is new doesn't automatically ensure that competitive
25 alternatives exist, or that Qwest should be given total pricing freedom. The proposed
26 settlement and referenced statutory provisions do not contain any criteria or provisions

1 which would allow the Commission to determine whether a new service properly belongs
2 in Basket 3, or whether it more appropriately belongs in a different basket.

3 In addition to the requirements of A.R.S. § 40-250, new product offerings should
4 be subject to the criteria and procedures contained in Commission Rule 14-2-1108. This
5 will reconfirm the Commission's authority to control rates and protect the public interest.
6 The mere fact that services are new does not mean that the public interest will best be
7 served by providing Qwest with extreme pricing flexibility. To the contrary, as
8 technology continues to advance, it is reasonable to expect that many newly offered
9 services will be important to users of the "information superhighway" and as such will
10 also be of considerable concern to the Commission.

11
12 *Pricing Provisions*
13

14 **Q. Let's turn to the fourth aspect of the settlement agreement you mentioned. Are there**
15 **any problems with the pricing flexibility provisions of the proposed price cap plan?**

16 A. Yes. The proposed plan contains a combination of price ceilings and price floors which
17 place some limitations on Qwest's pricing freedom. There are problems with both of
18 these aspects of the proposed plan.

19
20 **Q. What are the problems associated with the price ceilings?**

21 A. First, as I explained earlier, there is some potential uncertainty regarding the status of the
22 plan after the initial 3 year term. Qwest may request an extension or propose changes to
23 the plan, but it is not required to do so. Similarly, there may be a delay before the
24 Commission acts upon such a request. Yet, the caps on individual services in Basket 1,
25 and the Price Index mechanism for all services in Basket 1 only apply for the first three
26 years of the plan. It is unclear what would rule after three years, if the plan has not been
27 formally extended or modified. Qwest could be free to charge "what the market will bear"
28 for Basket 1 services.

1 Second, the proposed settlement would cap rates for certain Basket 1 services at
2 current levels, and limit increases to rates for other Basket 1 services to 25%. This
3 provides Qwest with too much pricing freedom because 25% is too loose a constraint,
4 and because it would be applied to services as a whole. Instead, the Plan should include
5 reasonable pricing limits on individual rate elements. This element-based approach
6 provides significant additional protection for customers--particularly those who use more
7 of a particular rate element than the average customer, and thus would be vulnerable to
8 extreme increases in their bills under the settlement proposal.

9 To illustrate this point, consider Measured Service (TIMCODE E5.2.1). This
10 tariffed service includes a monthly rate element, a weekday rate element and a
11 night/weekend/holiday rate element. It also includes a detailed billing rate element and a
12 nonrecurring rate element. Staff and Qwest's proposal does not place any constraints on
13 these individual service elements, provided the overall price increase for the service as a
14 whole stays below 25%. As a result, for example, Qwest could dramatically increase the
15 night/weekend/holiday rates while lowering certain other rates, such as the non-recurring
16 rates. Thus, customers that make most of their calls during the night/weekend/holiday
17 period could face severe rate increases. There is no reason to assume the impact on
18 individual customers would be reasonable merely because the service as a whole is
19 subject to a 25% limitation. The best way to protect customers from "rate shock" is to
20 limit the annual rate of increase in each individual rate element.

21 If the Commission were to provide Qwest with pricing flexibility, it should
22 impose reasonable constraints on this flexibility, in order to protect consumers from
23 extreme rate increases, and to ensure that any rate rebalancing is introduced gradually. By
24 capping individual rate elements, the Company is given less freedom to rapidly increase
25 rates, and customers will be given greater protection from rate shock during the interim
26 period while competitive pressures are building. Eventually, these pressures should make
27 it difficult for Qwest to impose extreme rate increases, and thus capping of individual rate

1 elements will be a moot issue. In the meantime, this is a needed protection which also has
2 the benefit of reducing Qwest's ability to engage in unreasonable price discrimination.
3

4 **Q. What limits do you recommend for individual rate elements?**

5 A. Reasonable annual percentage limits should be imposed, over and above the other
6 protections provided in the proposed plan. These rate element limits should be more
7 restrictive in categories where customers have the fewest opportunities to avoid price
8 increases. For example, the most essential services in the proposed baskets 1 and 2 (other
9 than UNEs) should be subject to a limitation on individual rate element increases of no
10 more than 3% in a year. Less stringent limits, such 5% per year, could be allowed for the
11 rate elements in other services. Finally, the limits on rate increases for elements in
12 services which are highly discretionary, but are not fully competitive, should be the least
13 strict of all, perhaps as high as 20% per year.
14

15 **Q. What about rate elements for services which have been declared to be fully**
16 **competitive?**

17 A. Under the settlement proposal, Qwest will have essentially unbridled discretion to price
18 services in basket 3 at profit maximizing levels. No caps will be needed on these rate
19 elements, as long as there is effective competition for all of the services in this basket. If
20 the Commission is concerned that the Company may have a lingering degree of monopoly
21 power in some of these markets, then the Commission should impose appropriate caps on
22 increases to individual rate elements in those services.
23

24 **Q. Can you now explain the problems associated with the pricing floor provisions of**
25 **Staff and Qwest's proposal?**

26 A. For retail services, the proposed Plan provides that each service must be priced above its
27 TSLRIC. The Plan provides the following: "Nothing in this price cap plan is intended to

1 change or modify in any way the imputation requirements contained in A.A.C. R14-1-
2 1310". [¶ 3(g)] Given the context in which this language appears, it appears that this
3 provision of the Plan might be limited to wholesale services. Rule 14-2-1310(C)
4 provides:

5
6 An incumbent local exchange carrier shall recover in the retail
7 price of each telecommunications service offered by the company
8 the TSLRIC of all nonessential, and the imputed prices of all
9 essential services, facilities, components, functions, or capabilities
10 that are utilized to provision such telecommunications service,
11 whether such service is offered pursuant to tariff or private
12 contract.
13

14 Rule 14-2-1302 defines "Essential Facility or Service" as
15

16 any portion, component, or function of the network or service
17 offered by a provider of local exchange service: that is necessary
18 for a competitor to provide a public telecommunications service;
19 that cannot be reasonable duplicated; and for which there is no
20 adequate economic alternative to the competitor in terms of
21 quality, quantity, and price.
22

23 **Q. Is 14-2-1310(C) limited to wholesale services?**

24 A. It does not appear to be. Rule 14-2-1301 provides that Article 13 applies "to the provision
25 of local exchange services by and between local exchange carriers..." To avoid and
26 confusion, if the proposed plan were to be approved, paragraph 3(g) should be moved
27 from the wholesale section to a more generic location, thereby making it clear that the
28 existing imputation rules apply to all services and all baskets.
29

30 **Q. Do you have any other concerns with regard to this provision of the proposed plan?**

31 A. Yes. For example, the Commission should clarify that the requirement to impute the price
32 of essential facilities and services applies even if the facility or service in question is not

1 essential for some competitors. For example, switched access service should be imputed
2 into the price floor for retail message toll service because this is essential for most
3 competitors, even though other options may exist for at least some competing carriers.
4 Similarly, the price of an unbundled loop should be imputed in the calculation of the
5 TSLRIC floor for a package of local exchange, custom calling and toll service, despite the
6 fact that the local loop may not be "essential" for Cox cable or the wireless carriers.

7
8 *Service Quality*
9

10 **Q. Finally, let's discuss the fifth aspect of the settlement agreement you mentioned.**
11 **Could you describe the service quality provisions of the proposal?**

12 A. The proposed settlement agreement provides that for any year in which Qwest becomes
13 subject to penalties under two or more of the five categories defined in Section 2.6 of the
14 Service Quality Plan Tariff, additional credits shall be implemented. The additional
15 credits will be in the form of one-time credits of \$2.00 for each residential and business
16 access line in Arizona. The Agreement further provides:

17
18 No service quality penalties or credits will be assessed during the initial
19 term of the price cap plan other than those provided for in the Service
20 Quality Plan Tariff as modified by Decision No. 62672 and in this
21 Agreement, except for any wholesale standards and penalties adopted in
22 Docket No. T-00000B-97-0238 or in any other Commission proceeding
23 addressing wholesale service quality standards or penalties. [§ 5]
24

25 **Q. Are these service quality provisions adequate?**

26 A. No. This is an area that clearly needs further scrutiny. The existing regulatory provisions
27 have not been adequate to ensure that every customer consistently receives high quality
28 service. While the settlement proposal takes some modest steps towards encouraging
29 better quality, these are not adequate, especially considering the increased incentives
30 which will exist under a price cap plan for Qwest to sacrifice quality in search of higher

1 profits. To the extent it can cut costs under a price cap system, even if this results in a
2 deterioration in service quality, this will enhance Qwest's profits, except to the extent any
3 resulting penalties or credits exceed the cost reduction in question. Furthermore, in an
4 increasingly competitive environment, Qwest will have a strong incentive to let its
5 wholesale quality (e.g. service connection intervals for unbundled elements)
6 deteriorate—since the adverse impact of this deterioration will primarily fall on its
7 competitors. If the Commission were to consider adopting a price cap plan, it will be
8 important to provide strong, comprehensive incentives for Qwest to improve and
9 maintain service quality, particularly for its UNEs and other wholesale offerings.
10

11 *Concluding Thoughts*
12

13 **Q. Do you have any concluding remarks you would like to make concerning the**
14 **proposed settlement?**

15 A. Yes. RUCO believes that the price cap plan as proposed in the settlement agreement
16 affords Qwest far too much pricing freedom, given the lack of effective competition for
17 most of Qwest's services in the state. In addition, existing provisions in the Arizona
18 Constitution which contemplate fair value rate base regulation impose limitations on the
19 type of regulation which is appropriate to use in this state. Moreover, it would be
20 inappropriate to enact sweeping changes in the Arizona regulatory structure through a
21 partial settlement involving just a few of the parties to this proceeding, and without
22 providing RUCO and other parties a full opportunity to thoroughly examine the
23 ramifications of the proposed changes, as well as various related issues. Finally, there are
24 specific aspects of the proposed settlement which are clearly not in the public interest,
25 including the excessive "going in" rate level and the lack of appropriate restrictions on
26 changes to individual rate elements. Accordingly, I would urge the Commission to reject
27 this proposal.

1 **Q. Does this conclude your direct testimony, prefiled on November, 13, 2000?**

2 **A. Yes, it does.**

3

Staff-Qwest Settlement Proposal*Net Revenue Change by Basket*

Element	Current Rate	Proposed Rate	Difference	Revenue Effect
Basket 1 Services				
Residence NRC - Low Use Option	\$ 46.50	\$ 35.00	\$ (11.50)	\$ (30,015)
Residence NRC - Flat Rate Service	46.50	35.00	(11.50)	(7,968,113)
Residence NRC - Reseller	35.47	26.70	(8.77)	(137,990)
Business Zone Connection Charge (NRC)	53.30	-	(53.30)	(170,720)
Residence Zone Connection Charge (NRC)	53.30	-	(53.30)	(2,267,789)
Business Zone 1 Change	1.00	1.00	-	(189,312)
Business Zone 2 Change	3.00	3.00	-	(192,888)
Residence Zone 1 Change	1.00	1.00	-	(1,497,276)
Residence Zone 2 Change	3.00	3.00	-	(1,941,876)
<i>Total Revenue Effect of Changes in Rate for Basket 1 Services</i>				\$ (14,395,979)
Basket 2 Services				
Carrier Common Line	\$ 0.01657 ¹	\$ 0.01586 ¹	\$ (0.00071)	\$ (1,189,627)
Switched Transport				(357,811)
Local Switching				1,528,156
Interconnection Charge	0.0062	0.0025	(0.0038)	(5,000,542)
Wholesale Directory Assistance	0.2255	0.3544	0.1289	5,224
<i>Total Revenue Effect of Changes in Rate for Basket 2 Services</i>				\$ (5,014,600)
Basket 3 Services				
Directory Assistance	\$ 0.47	\$ 0.85	\$ 0.38	\$ 24,572,391
Complete-A-Call	0.35 ²	- ²	(0.35)	(1,459,775)
Private Line Service				13,697,701
- Increase in Available Additional Revenue in Basket 3 Services Except Directory Services for One Year				\$ 25,300,000
<i>Total Revenue Effect of Changes in Rate for Basket 3 Services</i>				\$ 62,110,317
Overall Revenue Effect for All Baskets				\$ 42,699,738

¹ See Additional Detail in Attachment B to the Settlement Agreement² See Additional Detail in Appendix A to the Settlement Agreement

BJA Recommended Revenue Changes*Net Revenue Change by Basket*

Element	Current Revenue	Proposed Revenue	Difference
Basket 1 Services			
Local Residential Service	\$ 352,322,341	\$ 304,084,515	\$ (48,237,826)
Local Business Service	163,565,380	141,607,589	(21,957,791)
Market Expansion Line	3,543,776	2,984,232	(559,544)
Listings	14,774,548	24,224,536	9,449,989
Optional Features	38,993,527	46,413,060	7,419,533
Toll Restriction Services	2,730,280	8,790,438	6,060,158
Other Services	8,918	11,219	2,301
<i>Total Revenue Effect of Changes in Rate for Basket 1 Services</i>			\$ (47,823,181)
Basket 2 Services			
Switched Access Services	\$ 69,018,636	\$ 64,004,038	\$ (5,014,598)
Other Services	10,305,422	10,484,880	179,459
<i>Total Revenue Effect of Changes in Rate for Basket 2 Services</i>			\$ (4,835,140)
Basket 3 Services			
Long Distance Service	\$ 30,135,952.23	\$ 29,524,174.04	\$ (611,778.19)
Switched Access Services	1,414,301	1,436,475	22,174
Private Line Transport Services	26,308,198	31,937,577	5,629,379
Public Access Line Services	551,288	2,205,151	1,653,863
Directory Assistance	21,192,762	40,936,058	19,743,296
Other Services	355,844	590,038	234,194
<i>Total Revenue Effect of Changes in Rate for Basket 3 Services</i>			\$ 26,671,128
Overall Revenue Effect for All Baskets			\$ (25,987,192)